State of California

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Legislative Change No. 03-25

Bill Number: SB 614 Author: Cedillo & Burton Chapter Number: 03-656

Laws Affecting Franchise Tax Board: Sections 18407, 18628, 18648, 19116, 19164, 19166, 19173, 19177, 19179, 19504, 19715, 19751, 19752, 19753, 19754, 19755, 19772, 19773, 19774, 19777, 19778, and 21028 of the Revenue and Taxation Code

Date Filed with the Secretary of the State: October 2, 2003

SUBJECT: Tax Shelters & Tax Avoidance/Increase in Penalties Imposed/FTB Develop & Administer Voluntary Compliance Initiative

Senate Bill 614 (Cedillo & Burton), as enacted on October 2, 2003, made the following changes to California law:

Section 18407 of the Revenue and Taxation Code is added.

DISCLOSURE OF CERTAIN ITEMS ON TAX RETURNS.

In general

The act conforms to IRC Section 6011, and therefore, conforms to the section's underlying regulations requiring a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.

Transactions to be disclosed

This act defines the terms "reportable transaction" to mean any transaction of a type that the Secretary of the Treasury or the Franchise Tax Board determines as having a potential for tax avoidance or evasion including deductions, basis, credits, entity classification, dividend elimination, or omission of income and shall be reported on the return or statement required to be made.

Under these federal regulations, there are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to) a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction"). The federal regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax benefits and that is either factually similar or based on the same or similar tax strategy. Also, the term must be broadly construed in favor of disclosure.

The second category is any transaction that is offered under conditions of confidentiality. If a taxpayer's disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written, as to the potential tax consequences that may result from the transaction, it is considered offered under conditions of confidentiality (whether or not the understanding is legally binding).

Bureau Director	Date
Jana Howard for Brian Putler	11/17/03

The third category of reportable transaction is any transaction for which the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax consequences from the transaction will not be sustained. Such protection can include rescission rights, the right to a refund of fees, contingent fees, insurance protection with respect to the tax treatment, or a tax indemnity or similar agreement.

The fourth category of reportable transactions relates to any transaction resulting in, or that is reasonably expected to result in, a taxpayer claiming a loss (under section 165) of at least (1) $10 million in any single year or $20 million in any combination of years by a corporate taxpayer; (2) $5 million in any single year or $10 million in any combination of years by a partnership or S corporation; (3) $2 million in any single year or $4 million in any combination of years by an individual or trust; or (4) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.

The fifth category of reportable transactions refers to any transaction done by certain taxpayers in which the tax treatment of the transaction differs (or is expected to differ) by more than $10 million from its treatment for book purposes (using generally accepted accounting principles) in any year. The significant book-tax category applies only to taxpayers that are reporting companies under the Securities Exchange Act of 1934 or business entities that have $100 million or more in gross assets. The federal regulations exempt 13 types of transactions from the book-tax reportable transaction category.

The final category of reportable transactions is any transaction that results in a tax credit exceeding $250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.

The term “listed transaction” means a reportable transaction that is the same as, or substantially similar to, a transaction specifically identified by the Secretary of the Treasury or by the Franchise Tax Board as a tax avoidance transaction including deductions, basis, credits, entity classification, dividend elimination, or omission of income and shall be reported on the return or statement required to be made. The Franchise Tax Board must publish “listed transactions,” whether identified by the Internal Revenue Service or the Franchise Tax Board, on the Franchise Tax Board website, and in Franchise Tax Board notices or other published positions.

“Substantially similar” is defined in the Treasury regulations to mean any transaction that is expected to obtain the same or similar tax benefits and is either factually similar or based on the same or similar tax strategy. Opinions concluding that the tax benefits from the transaction are allowable are not relevant to the determination that a transaction is substantially similar to a listed transaction. The term “substantially similar” is to be broadly construed in favor of disclosure.

Presently the Internal Revenue Service has identified 25 “listed transactions”:

1. Notice 2003-24 - Certain Trust Arrangements Seeking to Qualify for Exception for Collectively Bargained Welfare Benefit Funds under § 419A(f)(5)
2. Notice 2003-22 - Offshore Deferred Compensation Arrangements
3. Revenue Ruling 2003-6 - Abuses Associated with S Corp ESOPs
4. Notice 2002-70– Certain Reinsurance Arrangements
5. Notice 2002-65– Pass-through Entity Straddle Tax Shelter
6. Notice 2002-50– Partnership Straddle Tax Shelter
7. Revenue Ruling 2002-46– §401k Accelerators
   Revenue Ruling 2002-73 - modifies Rev. Rul. 2002-46 for taxpayers electing to change method of accounting.

8. Notice 2002-35 – Notional Principal Contracts
   Revenue Ruling 2002-30 - Notional Principal Contracts

9. Notice 2002-21 – Inflated Basis "CARDS" Transactions

10. Notice 2001- 45 – §302 Basis-Shifting Transactions

11. Notice 2001-17 - §351 Contingent Liability

12. Notice 2001-16 – Intermediary Transactions
    Coordinated Issue Paper - Intermediary Transactions

13. Notice 2000-61 – Guam Trust

14. Notice 2000-60 – Stock Compensation Transactions

15. Notice 2000-44 – Inflated Partnership Basis Transactions

16. Revenue Ruling 2000-12 – Debt Straddles

17. Treasury Regulation § 1.7701(l)-3 – Fast Pay or Step-Down Preferred Transactions

18. Notice 99-59 – BOSS Transactions

19. Revenue Ruling 99-14 – Lease-In / Lease-Out or LILO Transactions

20. Treasury Regulation § 1.643(a)-8 – Certain Distributions from Charitable Remainder Trusts

21. ASA Investering Partnership v. Commissioner -Transactions similar to that described in the ASA Investering litigation and in ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998)

22. Notice 98-5, part II – Foreign Tax Credit Transactions

23. Notice 95-53 – Lease Strips

24. Notice 95-34 – Certain Trusts Purported to be Multiple Employer Welfare Funds Exempted from the Lists of §§ 419 and 419A

25. Revenue Ruling 90-105 – Certain Accelerated Deductions for Contributions to a Qualified Cash or Deferred Arrangement or Matching Contributions to a Defined Contribution Plan

These listed transactions are described in greater detail on the Internal Revenue Service's website at www.irs.gov.

For the failure to disclose a reportable transaction penalty please see Section 19772.

This provision is effective January 1, 2004. Except for persons that invest in a tax shelter that becomes a listed transaction, this section applies to taxable years beginning on or after January 1, 2003. For the limited purpose of applying Section 19778, relating to a higher interest rate for understatements of tax related to using a reportable transaction (which applies for taxable years beginning after December 31, 1998), the section applies for taxable years beginning after December 31, 1998.

<u>Section 18628 of the Revenue and Taxation Code is amended</u>.

TAX SHELTER REGISTRAION

Fully conforms to the federal tax shelter registration requirements (IRC Section 6111) with California modifications. The act supplements the present law rules with respect to registration of tax shelters. Modifications include California requiring additional information required by an FTB Notice. The act also provides conditions for registration of tax shelters as follows:

<u>(1) Organized in this state.</u>
<u>(2) Doing business in this state.</u>
<u>(3) Deriving income from sources in this state.</u>
<u>(4) At least one of its investors is a California taxpayer.</u>

A transaction entered into after February 28, 2000, that becomes a federal listed transaction at any time must be registered by the later of:

1. 60 days after entering the transaction,
2. 60 days after the transaction becomes a listed transaction, or
3. April 30, 2004.

The act specifies that transactions that become California only listed transactions are required to register if the transaction was entered into on or after September 2, 2003.

This provision is effective January 1, 2004. Except for persons that organize tax shelters that become listed transactions, this section applies on or after January 1, 2004. For any transactions entered into on or after February 28, 2000, that become federal listed transactions at any time, the registration required by the section cannot be due any earlier than April 30, 2004.

For the failure to register a tax shelter penalty, please see Section 19173.

<u>Section 18648 of the Revenue and Taxation Code is repealed and added</u>.

MAINTAINING TAX SHELTER INVESTOR LISTS

The act conforms to the federal provision (IRC Section 6112) requiring organizers and material advisers of potentially abusive tax shelters to maintain and provide a list with modifications. The material advisor must provide the list to the department within 20 days of request.

For transactions entered into after February 28, 2000, and become federal listed transactions at any time, an organizer or material advisor is required to automatically submit the list to the FTB no later than the later of:

1. 60 days after entering the transaction,
2. 60 days after the transaction becomes a listed transaction, or
3. April 30, 2004.

The act specifies that a material advisor is required to maintain and provide a list for transactions that become California only listed transactions entered into on or after September 2, 2003.

This provision is effective January 1, 2004. Except for persons that are material advisors for tax shelters that become listed transaction, this section applies on or after January 1, 2004. For any transactions entered into on or after February 28, 2000, that become federal listed transactions at any time, the registration required by the section cannot be due any earlier than April 30, 2004. The section does not apply to a licensed attorney for transactions entered into before January 1, 2004, if the attorney became a material advisor solely due to the practice of law.

For the penalty to maintain or provide a list, please see Section 19173.

<u>Section 19116 of the Revenue and Taxation Code is amended</u>.

SUSPENSION OF INTEREST

For taxpayers contacted by the FTB regarding the use of a potentially abusive tax shelter, the act provides that the suspension of interest provision does not apply to taxpayers with taxable income greater than $200,000.

The inapplicability of the suspension of interest provision for taxpayers with taxable income greater than $200,000 applies to notices mailed after January 1, 2004.

<u>Section 19164 and 19773 of the Revenue and Taxation Code is amended or added</u>.

ACCURACY RELATED PENALTY (Section 19164, amended.)

REPORTABLE TRANSACTIONS UNDERSTATEMENT PENALTY (Section 19773, added.)*In general* The act modifies the accuracy related penalty and creates a new reportable transactions understatement penalty in lieu of the accuracy related penalty. The two provisions are dependent on each other, and therefore, they are discussed together. The penalty rate and defenses available to avoid the penalty vary depending on the category of the transaction (i.e., listed or reportable transaction) and whether the transaction was adequately disclosed.

Disclosed transactions

In general, a 20% accuracy related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable transaction. The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the “strengthened reasonable cause exception”), which is described below. The strengthened reasonable cause exception is available only if the taxpayer has been contacted by the FTB and the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

Undisclosed transactions

If the taxpayer fails to adequately disclose the transaction, no reasonable cause exception is available (i.e., a strict-liability penalty applies), and the taxpayer is subject to an increased penalty rate equal to 30% of the understatement. The authority to rescind the 30% penalty can only be exercised by the Chief Counsel of the Franchise Tax Board and cannot be delegated. The taxpayer cannot appeal the Chief Counsel’s refusal to rescind a penalty.

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable transaction without regard to other items on the tax return. For purposes of this bill, the amount of the understatement is determined as the sum of --

> (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return). For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income, and
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> (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

A taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after when the taxpayer is first contacted regarding the potential abusive tax shelter transaction.

Strengthened reasonable cause exception

For taxpayers contacted by the FTB regarding the use of a potentially abusive tax shelter, a penalty is not imposed under the act with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires:

> (1) adequate disclosure (as previous discussed) of the facts affecting the transaction in accordance with the regulations under section 6011,
> (2) there is or was substantial authority for such treatment, and
> (3) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief:
>> (a) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and
>> (b) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that:
>>> (1) a return will not be audited,
>>> (2) the treatment will not be raised on audit, or
>>> (3) the treatment will be resolved through settlement if raised.

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is provided by a “disqualified tax advisor,” or (2) is a “disqualified opinion.”

Disqualified tax advisor

A disqualified tax advisor is any advisor who (1) is a material advisor[1] and who participates in the organization, management, promotion, or sale of the transaction or is related (within the meaning of section 267 or 707) to any person who so participates, (2) is compensated directly or indirectly[2] by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary of the Treasury or the Franchise Tax Board, has a continuing financial interest with respect to the transaction.

Organization, management, promotion, or sale of a transaction

A material advisor is considered as participating in the “organization” of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body. Participation in the “management” of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction.

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[1] The term “material advisor” (defined below in connection with the new information filing requirements for material advisors under new R&TC Section 19775) means any person who provides any material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons ($250,000 in any other case).

[2] This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

Participation in the “promotion or sale” of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

An advisor should not be treated as participating in the organization of a transaction if the advisor's only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a “disqualified tax advisor” with respect to the transaction if the advisor participates in the management, promotion, or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary of the Treasury or the Franchise Tax Board, has a continuing financial interest with respect to the transaction).

Disqualified opinion

An opinion may not be relied upon if the opinion (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events), (2) unreasonably relies upon representations, statements, finding, or agreements of the taxpayer or any other person, (3) does not identify and consider all relevant facts, or (4) fails to meet any other requirement prescribed by the Secretary of the Treasury or the Franchise Tax Board.

Coordination with other penalties

Any understatement to which a penalty is imposed for a reportable transaction understatement is not subject to the regular accuracy related penalty. However, such understatement is included for purposes of determining whether any understatement is a substantial understatement as defined the in the accuracy related penalty.

The penalty imposed under these provisions shall not apply to any portion of an understatement to which a fraud or non-economic substance transaction penalty is applied.

The changes made to Section 19164 apply to the accuracy related penalty assessed after January 1, 2004. Section 19773 applies to taxable years beginning on or after January 1, 2003.

CHANGES MADE TO THE SUBSTANTIAL UNDERSTATEMENT THRESHOLD FOR THE ACCURACY RELATED PENALTY ONLY

Definition of substantial understatement

For taxpayers contacted by the FTB regarding the use of a potentially abusive tax shelter, the act modifies the definition of “substantial” for corporate taxpayers (other than S corporations). A corporate taxpayer would have a substantial understatement if the amount of the understatement for the taxable year exceeds the lesser of (1) 10% of the tax required to be shown on the return for the taxable year (or, if greater, $2,500), or (2) $5 million.

Reduction of understatement for certain positions

The act elevates the standard that a taxpayer must satisfy in order to reduce the amount of an understatement for undisclosed items. With respect to the treatment of an item whose facts are not adequately disclosed, a resulting understatement is reduced only if the taxpayer had a reasonable belief that the tax treatment was more likely than not the proper treatment. The act also authorizes (but does not require) the Franchise Tax Board to publish a list of positions for which it believes there is not substantial authority or there is no reasonable belief that the tax treatment is more likely than not the proper treatment (without regard to whether such positions affect a significant number of taxpayers). The list shall be published in Franchise Tax Board Notices or other published positions. In addition, “listed transactions” notices shall be published on the Franchise Tax Board’s website.

This provision applies to penalties assessed on or after January 1, 2004.

<u>Section 19166 of the Revenue and Taxation Code is amended</u>.

TAX RETURN PREPARER PENALTY

The act alters the standards of conduct that must be met to avoid imposition of the penalty. The act replaces the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position was more likely than not the proper treatment. The act also replaces the not frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

In addition, the act increases the amount of the penalties. The penalty relating to not having a reasonable belief that the tax treatment was more likely than not the proper tax treatment is increased from $250 to $1,000. The penalty relating to willful or reckless conduct is increased from $1,000 to $5,000.

This provision applies to penalties assessed on or after January 1, 2004.

<u>Section 19173 of the Revenue and Taxation Code is amended</u>.

FAILURE TO REGISTER A TAX SHELTER OR MAINTAIN A LIST PENALTY

The act imposes a penalty of $15,000 on any organizer who fails to register a shelter or, or who files a false or incomplete registration. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $100,000, or (2) 50% of the gross income derived from the activity. Intentional disregard by an organizer of the requirement to register increases the penalty to 75% of the gross income. (Registration requirements in Section 18628.)

The penalty can be rescinded by the Chief Counsel of the Franchise Tax Board, but only in exceptional circumstances. All or part of the penalty may be rescinded but only if: (1) the transaction is not a listed transaction, (2) the organizer on whom the penalty is imposed has a history of complying with the state income tax laws, (3) it is shown that the violation is due to an unintentional mistake of fact, (4) imposing the penalty would be against equity and good conscience, and (5) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The organizer has no right to appeal a refusal to rescind a penalty.

Any organizer or seller of a potentially abusive tax shelter must maintain a list identifying each person who was sold an interest in any such tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions). Temporary regulations, applicable to transactions entered into after January 1, 2003, under section 6112 contain elaborate rules regarding the list maintenance requirements. (Maintaining lists requirements included in Section 18648.)

The penalty for failure to maintain and furnish the required list is a time-sensitive penalty. Thus, an organizer or material advisor who is required to maintain an investor list and who fails to make the list available upon request by the Franchise Tax Board within 20 business days after the request or for listed transactions fails to automatically provide the list will be subject to a $10,000 per day penalty. The penalty applies to a person who fails to maintain a list, maintains an incomplete list, or has in fact maintained a list but fails to provide the list to the FTB. The penalty can only be rescinded by Chief Counsel of the Franchise Tax Board under the same conditions as the penalty under the registration of tax shelters provision.

For providing a list to the department regarding listed transactions, rules similar to the tax shelter registration penalty becoming a listed transaction apply and would require a material advisor to automatically provide the list to the FTB when a transaction becomes listed. Thus, the amount of the penalty is the greater of (1) $100,000, or (2) 50% of the gross income derived from the activity. Intentional disregard by an organizer of the requirement to register increases the penalty to 75% of the gross income.

This provision applies to penalties assessed on or after January 1, 2004.

<u>Section 19177 of the Revenue and Taxation Code is amended</u>.

TAX SHELTER PROMOTER PENALTY

The act modifies the penalty amount to equal 50% of the gross income derived by the person from the activity for which the penalty is imposed. The new penalty rate applies to any activity that involves a statement regarding the tax benefits of participating in a plan or arrangement if the person knows or has reason to know that such statement is false or fraudulent as to any material matter. The enhanced penalty does not apply to a gross valuation overstatement.

This provision applies to penalties assessed on or after January 1, 2004.

<u>Section 19179 of the Revenue and Taxation Code is amended</u>.

FRIVOLOUS RETURN PENALTY

The act modifies the frivolous return penalty, for taxpayers contacted by the department regarding the use of a potentially abusive tax shelter, by increasing the amount of the penalty to a maximum of $5,000.

The act also modifies present law with respect to certain submissions that raise frivolous arguments or that are intended to delay or impede tax administration. The submissions to which this provision applies are requests for a collection due process hearing, installment agreements, offers-in-compromise, and taxpayer assistance orders. First, the bill permits the Franchise Tax Board to dismiss such requests. Second, the bill permits the Franchise Tax Board to impose a penalty of $5,000 for such requests, unless the taxpayer withdraws the request within 30 days after being given an opportunity to do so.

The act would require the Franchise Tax Board to publish a list of positions, arguments, requests, and submissions determined to be frivolous for purposes of these provisions.

The penalty can be only rescinded by the Chief Counsel of the Franchise Tax Board if: (1) imposing the penalty would be against equity and good conscience, and (2) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The taxpayer cannot appeal a refusal to rescind a penalty.

This provision applies to penalties assessed on or after January 1, 2004.

<u>Section 19504 of the Revenue and Taxation Code is amended</u>.

DEPARTMENT SUBPOENAS

For taxpayers contacted by FTB regarding the use of a potentially abusive tax shelter, the act expands the authority to sign a subpoena of the Franchise Tax Board to include the Executive Officer of the Franchise Tax Board or any designee.

This provision applies on or after January 1, 2004.

<u>Section 19715 of the Revenue and Taxation Code is amended</u>.

TAX SHELTER INJUNCTIONS

Under the act, an injunction may be sought against a material advisor to enjoin the advisor from (1) failing to file an information return with respect to a reportable transaction, or (2) failing to maintain, or to timely furnish upon written request by the Franchise Tax Board, a list of investors with respect to each reportable transaction.

This provision applies on or after January 1, 2004.

Chapter 9.5 (TAX SHELTERS) of Part 10.2 of the Revenue and Taxation Code is added.

Section 19751of the Revenue and Taxation Code is added.

VOLUNTARY COMPLIANCE INITIATIVE (VCI) AUTHORIZATION

This section authorizes the VCI allowing taxpayers that utilized abusive tax schemes to underreport their tax liabilities to amend their tax returns and come clean with the state. The VCI would be offered to taxpayers between the period January 1, 2004, and April 15, 2004, for taxable years beginning before January 1, 2003. The department is required to issue forms and instructions and take any other action necessary to implement the tax shelter provisions of Chapter 9.5 of Part 10.2 of the Revenue & Taxation Code, as added by this bill. The department is required to publicize the VCI to the highest degree possible. It is anticipated that the Franchise Tax Board will mail letters to all taxpayers identified as being involved in a potentially abusive tax shelter transaction or scheme. The letter will outline all provisions of this bill and encourage those taxpayers involved in an abusive transaction to take advantage of either Option A or B to avoid penalties. The act provides that the letter constitutes "contact" for purposes of determining if an amended return qualifies for certain penalty relief.

This provision applies on or after January 1, 2004.

Section 19752 of the Revenue and Taxation Code is added.

VCI ELECTIVE OPTIONS

This section provides the taxpayer with two elective options to participate in the VCI:

> Option A – Voluntary compliance without appeal rights, this option includes waiver of all penalties, including all existing and the new or increased penalties under this bill. The provision provides that if the taxpayer's amended return is accepted by the department, the issue would be considered closed. A closing agreement may be used. The taxpayer cannot file a claim for refund and the department cannot issue any deficiency assessment.
>
> Option B - Voluntary compliance with appeal rights, this option includes waiver of all existing and new or increased penalties, except the accuracy related penalty (as in effect prior to the passage of this bill). The provision provides that if the taxpayer's amended return is accepted by the department, the taxpayer may file a claim for refund for the tax and interest paid under the VCI. The six-month deemed denial of claims for refund would be suspended until the Franchise Tax Board takes action on the claim for refund or until the earlier of 180 days after a final federal determination of the transaction or four years after the claim was filed. If the taxpayer's claim prevails, a refund with interest will be issued. If the transaction is determined to be an abusive tax scheme, the taxpayer may also be liable for the accuracy related penalty under present law.

This provision applies on or after January 1, 2004.

Section 19753 of the Revenue and Taxation Code is added.

VCI LIMITATATIONS

This section provides that taxpayers who are subject to a criminal investigation or have a criminal compliant filed against them would not be eligible to participate in the VCI. Additionally, no refund or credit can be granted for any type of payment made prior to the taxpayer's participation in the VCI.

This provision applies on or after January 1, 2004.

Section 19754 of the Revenue and Taxation Code is added.

VCI QUALIFICATIONS

The VCI is extended to any type of abusive tax scheme, except those schemes using offshore accounts to shelter income, as described in Revenue Procedure 2003-11.

The taxpayer must file an amended return reporting all income and loss without regard to the abusive tax shelter scheme or transaction(s), and pay the tax and the interest. The taxpayer may request to pay the tax and interest under an installment agreement.

This provision applies on or after January 1, 2004.

Section 19755 of the Revenue and Taxation Code is added.

STATUTE OF LIMITATIONS EXTENDED TO EIGHT YEARS

The act extends the statute of limitations from four years to eight years for taxpayers who invest in an abusive tax avoidance transaction.

This section applies to any return filed on or after January 1, 2000.

Section 19772 of the Revenue and Taxation Code is added.

FAILURE TO DISCLOSE A REPORTABLE TRANSACTION PENALTY

The act creates a new penalty for certain persons who fail to include with any return or statement any required information with respect to a reportable transaction under Section 18407. The new penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any accuracy related penalty that may be imposed.

The penalty for failing to disclose a reportable transaction is $15,000. The amount is increased to $30,000 if the failure is with respect to a listed transaction. The penalty only applies to large entities and high net worth individuals.

A “large entity” is defined as any entity with gross receipts in excess of $10 million in the year of the transaction or in the preceding year. A “high net worth individual” is defined as any individual whose net worth exceeds $2 million, based on the fair market value of the individual's assets and liabilities immediately before entering into the transaction.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded or abated only if: (1) the taxpayer on whom the penalty is imposed has a history of complying with the California income tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the Chief Counsel of the Franchise Tax Board and cannot be delegated. The taxpayer cannot appeal a refusal to rescind a penalty.

Except as specifically provided, the provision applies to taxable years beginning on or after January 1, 2003. This penalty also applies to any person that is required to disclose a reportable or listed transaction under Section 18407 and the person invested in a transaction after February 28, 2000, and before January 1, 2004, where that transaction becomes a listed transaction at any time. (However, as indicated in a letter filed in the Senate Daily Journal on September 11, 2003, it is the intent of the Legislature that no penalty be imposed for California only tax shelter transactions entered into prior to September 2, 2003.)

<u>Section 19773 of the Revenue and Taxation Code is added</u>.

REPORTABLE TRANSACTION UNDERSTATEMENT PENALTY

Please see Section 19164 for the discussion of this penalty.

<u>Section 19774 of the Revenue and Taxation Code is added</u>.

NON-ECONOMIC SUBSTANCE TRANSACTION PENALTY

The act imposes a penalty for an understatement attributable to any transaction that lacks economic substance (hereinafter a “non-economic substance transaction understatement”). Thus, unlike the new accuracy related penalty discussed above (which applies only to listed and reportable transactions), the new penalty under this provision applies to any transaction that lacks economic substance. The penalty rate is 40%. The penalty is reduced to 20% if the taxpayer adequately disclosed the relevant facts on his or her tax return. For purposes of this penalty, adequately disclosed includes a taxpayer reporting the tax shelter identification number (a present law requirement) on his or her return. No exceptions (including the reasonable cause or rescission rules) to the penalty are available (i.e., the penalty is a strict-liability penalty).

A “non-economic substance transaction” means the disallowance of any loss, deduction or credit, or addition to income attributable to a determination that the transaction or arrangement lacks economic substance or a valid California business purpose. The penalty may also be assessed if an entity is disregarded because it lacks economic substance.

For purposes of this provision, the calculation of an “understatement” is made in the same manner as in the separate provision relating to new accuracy related penalty for listed and reportable avoidance transactions. Thus, the amount of the understatement under this provision would be determined as the sum of:

(1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return), and

(2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

Except as provided in regulations, the taxpayer's treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after the taxpayer is first contacted regarding potentially abusive transaction.

The penalty cannot be compromised without approval of the Chief Counsel of the Franchise Tax Board.

Any understatement to which a penalty is imposed under this provision will not be subject to the accuracy related penalty. However, an understatement under this provision would be taken into account for purposes of determining whether any understatement is a substantial understatement as defined accuracy related penalty provisions. The penalty imposed under this provision will not apply to any portion of an understatement to which a fraud penalty is applied.

This provision applies to penalties assessed on or after January 1, 2004.

<u>Section 19777 of the Revenue and Taxation Code is added</u>.

100% OF ACCRUED INTEREST PENALTY

The act creates a new penalty. For taxpayers contacted by the Franchise Tax Board, any underpayment of tax due to a potentially abusive tax shelter, as defined, a penalty equal to 100% of the accrued interest on the underpayment will apply. A potentially abusive tax shelter is defined as any transaction or scheme required to be registered under current federal law and is a reportable transaction under present federal law or state law under this act.

The penalty applies to notices mailed after January 1, 2004, and is in addition to any other penalty that may be assessed.

<u>Section 19778 of the Revenue and Taxation Code is added</u>.

50% INCREASE IN INTEREST RATE

For taxpayers not contacted by the Internal Revenue Service or the Franchise Tax Board regarding the use of a potentially abusive tax shelter, the act increases the prescribed interest rate by 50% for understatements of tax related to using reportable transactions as defined in this act.

The higher interest rate applies to any amended return filed after April 15, 2004, and for taxable years beginning after December 31, 1998.

<u>Section 21028 of the Revenue and Taxation Code is amended</u>.

TAX SHELTER EXCEPTION TO CONFIDENTIALITY PRIVILEGES RELATING TO TAXPAYER COMMUNICATIONS

The act modifies the exception relating to corporate tax shelters by making the exception applicable to all tax shelters, whether entered into by corporations, individuals, partnerships, tax-exempt entities, or any other entity. Accordingly, communications with respect to tax shelters are not subject to the confidentiality provision contained in the Revenue & Taxation Code that otherwise applies to a communication between a taxpayer and a federally authorized tax practitioner.

This provision applies as of January 1, 2004.

This act will not require any reports by the department to the Legislature. The act does require the department to provide information to the Legislative Analyst. The Legislative Analyst shall provide to the Legislature within two years a report regarding the impact of the act on tax shelters, state tax collections, and the state's business climate.